

COMMONWEALTH OF MASSACHUSETTS
DEPARTMENT OF PUBLIC UTILITIES

Investigation by the Department on its own motion as to the propriety of the rates and charges set forth in the following tariffs: M.D.T.E. No. 14, filed with the Department on January 16, 1998 to become effective February 14, 1998, by New England Telephone and Telegraph Company d/b/a Bell Atlantic-Massachusetts

D.P.U. 98-15, Phase II

**BRIEF OF AT&T COMMUNICATIONS OF NEW ENGLAND INC.
REGARDING AVOIDABLE COSTS IN THE CALCULATION
OF THE WHOLESALE DISCOUNT**

AT&T COMMUNICATIONS OF
NEW ENGLAND, INC.
By its attorneys,

Jeffrey F. Jones
Laurie S. Gill
Jay E. Gruber
Kenneth W. Salinger
Joseph F. Hardcastle
Matthew P. Schaefer
PALMER & DODGE LLP
One Beacon Street
Boston, MA 02108
(617) 573-0100

Melinda T. Milberg
32 Avenue of the Americas
New York, New York 10013
(212) 387-5627

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Introduction.

The establishment of an economically efficient wholesale rate based on the principles of sound economics and public policy embodied in the Telecommunications Act of 1996 ("1996 Act") is essential to the development of resale competition in Massachusetts. Competition through resale of wholesale services is an important first-step toward hastening the emergence of more potent, facilities-based competition in the Massachusetts local exchange market. In this brief, AT&T sets forth the legal, accounting and economic grounds for its position on the proper calculation of the avoided cost discount factor necessary to derive an economically efficient wholesale rate.

In addition, AT&T also addresses in this brief the significance of the decision of the Department of Telecommunications and Energy ("the Department" or "DTE") in Phase 2 of the arbitration proceedings conducted under the 1996 Act, in which the Department resolved the same issues now before it, prior to the Eighth Circuit Court of Appeals' decision vacating certain

parts of the FCC's Local Competition Order ("LCO" or "FCC Order"). *Iowa Utilities Board v. F.C.C.*, 120 F.3d 753, 796 (8th Cir. 1997), *cert. granted sub nom. AT&T Corp. v. Iowa Utilities Bd.*, 188 S.Ct. 879 (1998).

Governing Provisions of the 1996 Telecommunications Act.

Section 251(c)(4) of the 1996 Act imposes on incumbent local exchange carriers ("ILECs"), such as Bell Atlantic-Massachusetts ("BA-MA" or "Bell Atlantic"), the duty, among others,

(A) to offer for resale at wholesale rates any telecommunications service that the carrier provides at retail to subscribers who are not telecommunications carriers[.]

Section 252(d)(3) sets forth the pricing standard to be applied in determining the wholesale rates for telecommunications services to be resold:

For purposes of section 251(c)(4), a State commission shall determine wholesale rates on the basis of retail rates charged to subscribers for the telecommunications service requested, excluding the portion thereof attributable to any marketing, billing, collection, and other costs that will be avoided by the local exchange carrier.

The Department has correctly identified its goal as a state commission establishing wholesale rates under § 252(d)(3):

Our goal should be to establish rates for resellers that only pay for the costs incurred by the ILEC to supply the wholesale services they are using and not the costs incurred by the ILEC to supply retail services with which they are competing.

Consolidated Arbitrations, D.P.U. 96/73-74, 96-75, 96-80/81, 96-83, 96-94, Phase 2 Order ("Phase 2 Order") at 9. This over-arching principle embodies the proper economic principles necessary to promote efficient competition in the local exchange market through resale, pending viable facilities-based competition from entering LECs. AT&T's proposed avoided cost study submitted in this proceeding is entirely consistent with this goal and the standard of the 1996

Act; BA-MA's proposed cost study, by contrast, grossly underestimates total avoided costs and seeks to protect its monopoly position in the local retail market by requiring its retail competitors to subsidize BA-MA's retail operations through an inflated wholesale rate. The Department should reject BA-MA's fundamentally flawed cost study and adopt instead the methodology, study, and wholesale discount advanced by AT&T.

The AT&T Avoided Cost Study.

(DIRECT CASE)

AT&T and Bell Atlantic agree that the proper method for determining wholesale rates under the Act is to calculate a wholesale discount to be applied to Bell Atlantic's existing retail rates by determining the ratio of total avoided costs (numerator) to total revenues from services subject to resale (denominator).¹ Both parties have used the data reported in Bell Atlantic's 1996 Automated Report Management Information System ("ARMIS") annual reports filed with the FCC as the basis for their avoided cost studies. Testimony of Douglas K. Goodrich on behalf of AT&T Communications of New England, Inc. dated August 14, 1998. ATT-Phase II-3 at 8 ("Goodrich Test."). AT&T's avoided cost study shows a permanent avoided cost discount of 30.75% for resellers who provide their own operator and directory assistance services ("O+DA") and a permanent avoided discount for resellers who purchase operator and directory assistance services from BA-MA of 25.83%. Goodrich Test. at 3, 4.

I. DIRECT COSTS

In calculating the wholesale discount, AT&T's Avoided Cost Study (Goodrich Test. and accompanying exhibits and workpapers) treats as 100% avoided the direct costs recorded in the following USOA accounts which reflect direct costs of serving retail customers:

¹ Both AT&T and BA-MA have excluded from their avoided cost studies the costs of provisioning public coin services and E911 service.

!	6611	product management
!	6612	sales
!	6613	product advertising

Goodrich Test. at 9-11.² In addition, AT&T's avoided cost study treats customer service expenses, account 6623, which with limited exceptions records costs of serving retail customers, as 87.88% avoided. *Id.* at 11.

Next, AT&T's study reflects that costs for call completion (account 6621), number services (account 6622) and operator system expense (account 6620) are avoided when AT&T provides its own operator and directory assistance services, to the extent of the loss or "shortfall" (the amount by which expenses exceed revenues) Bell Atlantic experiences on such services. *Id.* and Workpaper 1.

AT&T's cost study also reflects that Bell Atlantic avoids 32.05% of its expenses in account 6533, operations testing, because the cost of repair inquiries and other services will be borne by the reseller's customer service personnel. *Id.* at 32-33

Finally, with respect to direct expenses, AT&T's avoided cost study shows that the portion of account 6560, depreciation and amortization expense, related to operator and directory assistance assets, will be 100% avoided, because AT&T will provide its own O+DA and will not require use of the assets associated with such services. Goodrich Test. at 34-35, and Ex. 1 attached thereto, p. 1 of 3.

II. INDIRECT COSTS

AT&T's Avoided Cost Study determines the amount of indirect expenses by applying a ratio so that indirect expenses are avoided in proportion to avoided direct expenses. This is the

² These accounts were deemed to be presumptively avoidable by the FCC in the LCO and the FCC Rules. *See* 47 C.F.R. § 51.609(d).

approach adopted by the FCC. *See* 47 C.F.R. § 51.609 and LCO ¶ 918. Consistent with applying the ratio established by dividing total avoided direct costs by total direct costs, AT&T's Avoided Cost Study treats as avoided a portion of the indirect costs recorded in the following USOA accounts:

!	5301	telecom uncollectible expense ³
!	6121-6124	general support expenses (<i>e.g.</i> , land, buildings, furniture, office equipment, general purpose computer)
!	6711	executive
!	6712	planning
!	6721-6728	corporate operations expenses (<i>e.g.</i> , accounting and finance, external relations, human resources, information management, legal, procurement, research and development, other general and administrative)

See, Goodrich Test. at 13-14 and Ex. 1, p. 2 of 3.

AT&T's Avoided Cost Study also treats as avoided (and provides a justification therefor) portions of the following indirect expense accounts:

!	6560	depreciation and amortization expense associated with general support assets
!	7240	operating taxes

Id., at 14-15, 34, 45 and Ex. 1, p. 2 of 3. Finally, AT&T's Avoided Cost Study treats as an avoided indirect expense (and provides a justification therefor) a portion of the return associated with general support assets. *See, id.* at 15 and Ex. 1, p. 2 of 3.⁴

³ AT&T did not rely on the presumption of proportionality in ¶ 918 for uncollectibles, because AT&T had substantial evidence upon which to base a different conclusion. In the present interexchange access market, BA-MA's uncollectibles expense is negligible. In a local service resale environment, BA-MA will likely serve a limited number of well capitalized wholesalers. The uncollectibles experience should reflect BA-MA's actual experience in the interexchange access wholesale market. AT&T and Bell Atlantic agree that uncollectibles are 99.87% avoided. *See* Goodrich Test. at 13-14.

⁴ *See also*, Local Competition Order, ¶ 913 (portion of return on investments attributable to assets used in (continued...))

AT&T and Bell Atlantic's respective studies agree on the percent of avoided costs in a number of the categories just described. For example, the Parties agree that Sales (account 6612) is 100% avoided, Customer Services (account 6623) is 88.78% avoided and the costs of Operations Testing (account 6533) are 32.05% avoided. The parties also agree that the proper way to calculate avoided costs related to operator and directory assistance services is to calculate the "shortfall" and deem it avoided. There are, however, fundamental flaws in the both methodology and avoided cost projections contained in the Bell Atlantic study, which cause it to grossly underestimate the amount of avoided costs.

The Fundamental Errors In The Bell Atlantic Cost Study: Overview.

Bell Atlantic's cost study contains the following fundamental errors:

1. Bell Atlantic improperly uses "separated" data, rather than whole company data, so that its study does not reflect even full the amount of costs that Bell Atlantic concedes are avoided, but instead calculates the discount based on only the costs which are allocated to the intrastate jurisdiction, significantly understating Bell Atlantic's avoided costs and the resulting wholesale discount;

2. Bell Atlantic improperly excludes expenses from its avoided costs that it acknowledges are solely attributable to its retail operations, on the grounds that such costs are "fixed," thereby expecting its potential retail competitors to subsidize Bell Atlantic's retail business and preventing competition by certain efficient resellers;

3. Bell Atlantic incorrectly asserts that its advertising expenses, which it concedes are currently spent entirely to promote its retail business, are 100% not avoided, on the bare grounds that such costs are "fixed" or, in the alternative, on the unsupported assertion that

(...continued)
avoided retail activities should be treated as avoidable costs).

BA-MA will advertise as a monopoly wholesaler in order to stimulate general retail demand;

4. Bell Atlantic deems 67% of its product management expenses to be not avoided on the grounds that expenses spent developing and improving its own *retail* products inevitably support its wholesale business because it must offer such products at wholesale, ignoring that its wholesale operations would be supported resellers' product management expenditures;

5. Bell Atlantic incorrectly calculates the level of indirect avoided costs, purporting to do a function code by function code analysis but in fact merely asserting that a large percentage of indirect costs are fixed and therefore unavoidable, while applying a mathematically incorrect ratio to most of the remaining indirect expenses; and

6. Bell Atlantic fails to include as avoided amortization and depreciation costs on assets devoted to operator and directory assistance, which AT&T will not be using in providing its own O+DA, and fails to include as avoided a portion of costs for return and taxes on such investments, of expenses for operating taxes, and of costs for amortization and depreciation of general support assets.

The economically unsound and methodologically improper use of separated data by Bell Atlantic causes Bell Atlantic to begin its analysis of avoided costs with an artificially reduced pool of costs. Its indefensible decision to exclude fixed costs including retail advertising costs, that it concedes are attributable solely to its retail operations decreases its avoided cost number even more and aggravates the error when applied to indirect expenses as well. Its assertions about alleged wholesale advertising are utterly without support, and its exclusion of product management costs that are devoted to retail services demand a subsidy from competing resellers. This brief addresses these errors at length below, but first addresses the Department's decision in Phase 2 of the consolidated arbitration proceedings conducted pursuant to the 1996 Act, in

which the Department rejected the major failings in Bell Atlantic's current cost study.

The Phase 2 Order.

In response to petitions from several CLECs, in mid-1996 the Department commenced arbitration proceedings in accordance with the 1996 Act. D.P.U. 96-73/74, 96-75, 96-80/81, 96-83, 96-94. Phase 2 of that consolidated docket concerned the issue of the appropriate amount by which NYNEX/Bell Atlantic retail services would be discounted for resale.

The parties to the arbitration filed testimony and studies concerning BA-MA's avoided costs in accordance with certain rules set forth by the FCC. In 1996, the FCC promulgated specific rules for determining wholesale rates on the basis of expenses recorded in specific accounts, which were consistent with the provisions of the FCC's discussion in its Local Competition Order. *See* C.F.R. § 51.609. The Rules and order established a guiding methodology for calculation avoided costs under § 252(d)(3) **B** defining avoided costs as those costs an incumbent LEC would no longer incur if it were to cease retail operations and provide all its services through resellers (LCO, ¶ 911) **B** as well as certain presumptions regarding the treatment of various costs as avoided or not avoided. *See id.*

In October 1996, after the parties filed their respective testimony and avoided cost studies in Phase 2 of the arbitration but before the hearings, the United States Court of Appeals for the Eighth Circuit issued a decision staying the effect of the pricing portions of the FCC rules, pending final adjudication on a complaint filed by certain state commissions and ILECs challenging the FCC's authority to regulate intrastate telecommunications service. *Iowa Utilities Board v. F.C.C.*, 109 F.3d 418, (8th Cir.), motion to vacate stay denied, 117 S.Ct. 429 (1996).

Faced with the stay, the parties agreed that the hearings in the arbitration should proceed based on the testimony and studies as filed to comport with the FCC rules. *See* Transcript of

Arbitration Hearings dated October 21, 1996 at 4-10.⁵ In issuing its written decision, the Department treated the FCC rules as applicable and decided that it should not reach conclusions concerning the appropriate pricing methodologies for resold services based on the record before it. Phase 2 Order at 8. At the same time, the Department was guided by relevant provisions of the 1996 Act and addressed issues on which the 1996 Act and (stayed) FCC order were silent. *E.g.*, Phase 2 Order at 8-9, 13. On such issues, the Eighth Circuit's order was of no relevance whatsoever, where the Department's interpretations and determinations were not based on the FCC Order or Rules.

The Eighth Circuit's Final Decision.

The Department is once again confronted with the issues presented in Phase 2 of the arbitration because, subsequent to its Phase 2 Order, the Eighth Circuit issued a decision, now on appeal to the Supreme Court by AT&T and others, vacating the FCC pricing rules. *Iowa Utilities Board v. F.C.C.*, 120 F.3d 753, 796 (8th Cir. 1997), *cert. granted sub nom. AT&T Corp. v. Iowa Utilities Bd.*, 118 S.Ct. 879 (1998). In vacating the FCC Rules, the Eighth Circuit did not offer an opinion concerning the economic soundness of the wholesale discount rules and presumptions established by the FCC. Rather, the Eighth Circuit merely held that the 1996 Act granted the state commissions, and not the FCC, the authority to establish local rates in accordance with the statutory standards of the Act. *Iowa Utilities Board v. F.C.C.*, 120 F.3d at 796.

The status of the FCC rules at the time of the Phase 2 arbitrations and the subsequent

⁵ AT&T cites to the October 21, 1996 arbitration transcript because the Hearing Office in this proceeding directed the parties to address the meaning of the Phase 2 arbitration decision in light of the Eighth Circuit's action and to include a discussion of relevant portions of the transcript. AT&T expressed its objections to the inclusion of such transcript citations, because they reflect material which is not in the record in this case, and hereby further reserves its right to object to the inclusion of such pages.

ruling vacating them raise two sorts of questions in reviewing the Phase 2 Order. First, the parties asserted that, absent the FCC rules and guided solely by the Act, they might have presented different studies and evidence to the Department on the issue of avoided costs. Second, a close reading of the Department's decision is necessary to conclude to what extent the Department acted merely to enforce the FCC rules, and on what issues the Department ruled based on the broad principles underlying the 1996 Act and on its own assessment of the proper economic and public policy to carry out those principles.

The Department's Authority To Adopt The FCC Rules.

Because the Eighth Circuit offered no opinion on the substance of the FCC rules, the Department is free and should adopt in this proceeding the well-reasoned methodologies and presumptions set forth in the LCO and the FCC Rules. Sound economic theory supports the FCC's basic premises that avoided costs should be calculated as if Bell Atlantic were no longer providing retail services, but instead was a wholesale only provider. *See generally* Testimony of Janusz A. Ordoover on behalf of AT&T Communications of New England, Inc. dated August 14, 1998, AT&T-Phase II-1 ("Ordoover Test.") at 22-29. Moreover, in order to permit decision making, the Department should adopt the presumptions employed by the FCC concerning categories of avoided cost. As Dr. Ordoover testified, presumptions placing burdens of proof according to access to information and other factors are a necessary tool for deciding important public policy questions where the Department is presented with inadequate information to form reliable conclusions. Ordoover Test. at 23-25.

In setting either permanent or interim resale rates, at least four states have adopted pricing principles for unbundled network elements and for total service resale that are consistent with the FCC Report and Order and the presumptions therein. For example, the New Jersey

Board of Public Utilities has stated that:

The FCC in its Report and Order at ¶ 909 adopted a minimum set of criteria for avoided cost studies used to determine wholesale discount rates, based on avoided costs by Uniform System of Accounts (USOA) expense accounts that are cast as rebuttal presumptions. (FCC Order at ¶ 909) While the Eighth Circuit Court decision vacated the FCC Order [footnote omitted], the Board, however, does agree with the rationale employed by the FCC for determining an avoided cost methodology and sees no need to modify this decision based on the Eighth Circuit Court Decision.

* * *

We concur with the FCC's rejection of the ILEC's arguments that they must actually experience a reduction in their operating expenses for a cost to be considered "avoided" for purposes of § 252(d)(3), and its reasoning that Congress did not intend to allow ILECs to sustain artificially high wholesale prices by not reducing their expenditures to the degree that certain costs are readily avoidable. We further concur that an objective assessment of what costs are reasonably avoidable when a LEC sells its services at wholesale should be made. Therefore, the Board FINDS that the "reasonably avoidable" standard is the appropriate methodology to be utilized.

New Jersey Board of Public Utilities, *In the Matter of Investigation Regarding Local Exchange Competition for Telecommunications Services*, Docket No. TX95120631; *see also* Rhode Island

Public Utilities Commission, Docket No. 2518, *Rules Regarding "Avoided Cost" for Development of "Wholesale" Discounts from Retail Rates* (promulgated January 29, 1998; effective March 1, 1998), § IV.A (adopting specific rules that closely parallel FCC rules);⁶

Minnesota Public Utilities Commission, *In re US West Communications, Inc.*, Docket No. P-442, 5321, 3167, 466, 421/CI-96-15490, Order dated March 12, 1997 at 7-8 (reaching independent conclusions closely paralleling FCC's).

⁶ The Rhode Island Commission, however, while properly adopting the "avoidable" cost principle and presumptions paralleling those established by the FCC, improperly adopted the separations approach in establishing its regulations. For the reasons discussed herein, the separations approach is wrong as a matter of economics and conflicts with the language and principles of the 1996 Act. The Rhode Island Commission, therefore, erred in establishing the total expenses from which to determine avoided expenses (because it improperly separated costs allocated to the interstate jurisdiction), but correctly concluded that the proper measure is avoidable costs, to be determined in accordance with sound presumptions regarding which cost are to be deemed avoidable.

In response to a challenge of its methodology, the Oregon Commission stated:

GTE also challenges the Arbitrator's reliance on the FCC's methodology to set a wholesale discount rate. GTE renews its argument that the Commission may not refer to or base a decision on the stayed FCC pricing rules. We disagree. As noted by the Arbitrator, the FCC rules represent a thorough, comprehensive analysis of issues related to interconnection and provide useful guidance for the resolution of the pricing issues in this proceeding. It was not error for the Arbitrator to agree with and adopt the FCC's conclusions, including those regarding the avoidable costs in the particular USOA accounts.

Oregon Public Utilities Commission, *In re Sprint Communications Company, L.P.*, Order No. 97-053, Decision dated February 18, 1997 at 5.

AT&T believes the Department should follow the FCC rules because they are economically sound. Ordover Test. at 22-23. Whether or not the Department formally adopts the methodologies and presumptions adopted by the FCC, the FCC rules remain persuasive authority representing the judgment of the FCC based on detailed review of the relevant factors. The Eighth Circuit vacated the rules based on a lack of FCC jurisdiction, they nevertheless represent appropriate rules for wholesale discounts based on economic principles and on the plain language of the Telecommunications Act.

**Argument Regarding Principal
Points in Dispute Between AT&T
and BA-MA Avoided Cost Studies.**

I. THE DEPARTMENT SHOULD REJECT THE USE OF "SEPARATED" DATA IN THE CALCULATION OF AVOIDED COST DISCOUNT FACTOR.

Bell Atlantic's cost study begins from an inappropriate premise before it even begins to analyze which costs are avoided. BA-MA's avoided cost study is improperly based on only those expenses that have been *allocated* by the separations process to the intrastate jurisdiction. The problem with using separated data is that it produces an avoided cost discount factor that

does not reflect all the costs avoided by BA-MA. This penalizes resellers and provides a windfall to BA-MA. Use of separated data is wrong as a matter of law and economics for the reasons set forth below.

A. The Separations Approach Does Not Comply With the Act.

BA-MA's use of the separations approach produces results that are directly contrary to the clear intent of the Act. The effect of BA-MA's position would be to impose *a requirement that resellers subsidize incumbent LECs*, which creates a windfall gain for the LECs and a barrier to entry for the resellers. The reseller-to-LEC subsidy occurs under the separations approach, because the costs that the LEC actually avoids are greater than the difference between the wholesale and retail price. Put another way, the reseller is paying more to the LEC than it costs the LEC to provide the wholesale service after taking into account the subsidy that the LEC is receiving from exchange access services.⁷ This means that the cost to the reseller to provide the retail service will be artificially inflated, making it impossible for the reseller to compete with the LEC on equal terms. This result could not possibly have been intended by an Act that was passed to promote competition in the local exchange market and, in particular, competition between the incumbent LEC and resellers.

Section 252(d)(3) of the Act requires that the numerator include all costs that will be avoided if the LEC ceases retail operations. Section 252(d)(3) makes no distinction between **B** or even reference to **B** costs allocated to the interstate and intrastate jurisdictions. Rather, the specific language of section 252 provides that "A State Commission shall determine wholesale rates on the basis of retail rates charged to subscribers for the telecommunications service

⁷ Adding insult to injury is the fact that resellers who are also interexchange carriers, such as AT&T, are funding the subsidy to LECs in the first place through the payment of access charges priced well above cost. AT&T, therefore, would be paying the LEC twice for costs that it actually avoids which are allocated to the interstate jurisdiction.

requested, excluding the portion thereof attributable to any marketing, billing, collection and other costs that will be avoided by the local exchange carrier."

There is nothing in the statute that limits "the portion thereof attributable to any marketing, billing, collection and other costs that will be avoided by the local exchange carrier" to costs allocated to the intrastate jurisdiction. Thus, the Act requires the Department to consider and to exclude from the numerator all "costs that will be avoided" by Bell Atlantic. Moreover, given that the Act offers no similar direction to the FCC with respect to interstate rates and jurisdictionally interstate avoided retailing costs, the interpretation of Section 252(d)(3) as referring to total company costs is the only one that makes sense. Permitting any ILEC (such as Bell Atlantic) to charge wholesale rates based only on a portion of its avoided costs through the "separations" process would permit it to charge resellers for costs it has actually avoided. Such an anticompetitive result is not consistent with the mandate of Section 252 or the Act as a whole. The Department should reject the use of "separated" data in the calculation of the avoided cost discount factors and should order that the discounts rates used to establish the wholesale rates for resold services be calculated using Massachusetts-specific costs on an unseparated basis.

B. The Economic Principles Underlying the Act and the Way in which the Separations Approach Violate Them.

The separations approach subtracts from the denominator in the ratio of avoided costs (numerator) to revenues subject to resale (denominator), those revenues generated by interstate exchange access services and other interstate revenue associated with services not subject to resale. It subtracts from the numerator those amounts that are allocated to the interstate jurisdiction (although not necessarily causally related to the provision of interstate services). As a result, all intrastate revenues actually generated by intrastate services are in the denominator, but not all of the avoided costs related to the provision of intrastate services are in the numerator;

only those avoided costs that are actually *allocated* to the intrastate jurisdiction are in the numerator. The effect is that the share of the avoidable cost in total intrastate revenues is too low and so is the wholesale discount.

The error caused by the use of separated data is that it produces an avoided cost discount factor that does not reflect all the costs that will, in fact, be avoided by Bell Atlantic. This penalizes resellers and provides an unfair competitive advantage to Bell Atlantic. It creates distorted price signals under which resellers who are more efficient than Bell Atlantic in their retail operations will nevertheless be unable to compete. Hence, the retail discount should be based on all costs that are potentially avoidable. *Ordovery Test.* at 37.

To illustrate, refer to the example in Dr. Ordovery's testimony of an incumbent LEC incurring costs of \$10 per unit to provide a certain service at retail, and only \$6 per unit to provide the same service at wholesale. A reseller that could provide the retail function itself for less than \$4 would be more efficient than the ILEC and should provide the entire service at retail at a lower total price. However, if separated data were used so that only a portion of the costs that are actually avoidable (say, \$2 of the \$4 that are avoidable) are allocated to the state jurisdiction, a reseller that is more efficient than Bell Atlantic might nonetheless be unable to compete with Bell Atlantic because the separations approach would reduce the size of the wholesale discount, requiring a reseller to spend more on the wholesale service, and to charge a higher retail price than BA-MA to recover its costs. *Id.* at 44-45.

C. The Department Rejected the Use of Separated Data In Phase 2 of the Arbitration as Inconsistent with the "Top-Down" Method of Calculating Wholesale Rates prescribed by the Act.

The Department rejected BA-MA's proposal to use separated data in Phase 2 of the arbitration. *See* Phase 2 Order at 33. The Department's decision in that proceeding was not

based on the dictates of the FCC Order or Rules, but rather on its own conclusion that using separated data is inconsistent with the "top down" calculation of the wholesale discount. The "top down" calculation of the wholesale rates differs fundamentally from a rate proceeding in which the goal is to determine the appropriateness of including expenses in retail rates. The Department emphasized this point in its Phase 2 Order:

"As noted by AT&T and Sprint, the purpose of this proceeding to look at the actual expenses incurred by NYNEX and to determine which of those expenses would be avoided if it were a wholesale company. We are creating a ratio, not determining a revenue requirement. Just as in the case of advertising, we do not seek to determine which expenses are allowable in retail rates. The jurisdictional distribution of those costs, whether based on an arbitrary interstate/intrastate separation process or, indeed, our own intrastate ratemaking methodology, is not relevant.

Sprint has succinctly stated the appropriate basis for resolving this issue: Costs will not avoided based on jurisdiction, but in total. In addition, we agree that to base the avoided cost determination on the separations process would be to impute a policy of shifting avoided costs between jurisdictions, in the manner historically used to shift local costs to the long distance jurisdiction."

(Phase 2 Order at 33.)

Dr. Taylor's defense of the use of separated data is directly contrary to the Act's "top-down" methodology. *See* Degnan Rebuttal at 5-7. Dr. Taylor asserts that the use of separated data is supported by the language of § 252(d)(3), which calls for the exclusion of "the portion of [the retail rates] attributable to any marketing, billing, collecting and other costs that will be avoided." In effect, Dr. Taylor contends that costs allocated to the interstate jurisdiction are not "in" the retail price and therefor can never be consider a "portion thereof." BA-Phase II-2 at 5. Dr. Taylor's formulation is disingenuous and inconsistent with the policies of the 1996 Act and the mechanism by which it establishes wholesale prices. First, Dr. Taylor himself acknowledges (as the Department found in its Phase 2 Order) that BA-MA's retail rates are not cost based, and

so there is no sense in which costs allocated by the separations process are in, or out of, retail rates. Transcript of Hearing Volume No. 4, October 1, 1998 ("Tr. Vol. 4") 434:18-435:5. His interpretation of § 252(d)(3) is therefore, by his own admission, contrary to the "top-down" methodology prescribed by that section, and must be rejected.

Bell Atlantic offers no defense of its use of separated data other than Dr. Taylor's unpersuasive interpretation of § 252(d)(3). The vague speculation (Testimony of Margaret Mary Degnan dated January 16, 1998, BA-Phase II-3 ("Degnan Direct"), at 5) that if the FCC eliminates the subsidy Bell Atlantic enjoys in its access charges by virtue of the separations process, that Bell Atlantic will somehow fail to recover the full amount of its intrastate costs, amounts to nothing more than speculation. Moreover, because Bell Atlantic has *avoided* the intrastate cost, there is no danger of underrecovery. The Department should, in any event, set the wholesale discount as required by the Act and leave to the FCC the job of reconciling the separations rules with the Act.

Because the use of separated data is inconsistent with the broad methodology for calculating the wholesale discount mandated under § 252(d)(3) and with basic economic principles of promoting efficient competition, it must be rejected. The Department should use full company data in calculating the wholesale discount.

II. BELL ATLANTIC IMPROPERLY EXCLUDES FIXED COSTS OF PROVIDING ITS RETAIL SERVICES FROM THE CALCULATION OF AVOIDED COSTS

The next major flaw in Bell Atlantic's cost study that causes it to grossly underestimate the amount of avoided costs (and the corresponding discount) is its refusal to recognize as avoided all exclusively retail-related costs incurred by Bell Atlantic. Instead, although it concedes that these costs are related solely to providing retail services (Tr. Vol. 4 at 408:23-409:1), Bell Atlantic contends that its alleged "fixed" costs of providing retail services are not

avoided. Degnan Direct at 4; Testimony of William E. Taylor on behalf of Bell Atlantic-Massachusetts dated January 16, 1998, BA-Phase II-1 ("Taylor Direct"), at 7-9; Tr. Vol. 4 at 484:3-5. Bell Atlantic's contention that avoided costs should be calculated based on only those costs Bell Atlantic would avoid in shifting from a retail to a wholesale and retail provider of services, and thus excluding so called fixed costs which do not vary with the volume of retail output, is economically unsound and causes a gross understatement in the wholesale discount. By contrast, AT&T's assumption, that Bell Atlantic's avoided costs should be calculated using the construct that Bell Atlantic sheds all its retail operations and acts solely as a wholesaler, identifies all retail-related costs an efficient wholesale provider could avoid in the long-run and thus promotes efficient competition under the Act.

A. AT&T's Cost Study Properly Analyzes Avoided Costs As If Bell Atlantic Were Providing Only Wholesale Services.

AT&T's cost study is based on the construct that Bell Atlantic sheds all of its retail functions and acts as a provider of only wholesale services. Goodrich Test. at 18-20; Tr. Vol. 4 at 592:16-24.⁸ As demonstrated by Dr. Ordovery, the assumption that Bell Atlantic acts exclusively as a provider of wholesale service is sound economics and necessary to prevent a situation in which otherwise efficient resellers are excluded from the market. Ordovery Test. at 17; Tr. Vol. 3 at 361:22-362:15.

The Act's goal of promoting competition in the provision of local exchange services requires that the wholesale discount be set at a level that will allow a reseller that is as efficient

⁸ This application of this construct for purposes of identifying Bell Atlantic's retail-related costs and calculating the wholesale discount does not mean that AT&T contends that Bell Atlantic will lose all of its retail customers overnight. Indeed, both Mr. Goodrich and Dr. Ordovery stressed that they fully expect Bell Atlantic will continue to provide retail services even in a resale environment. Tr. Vol. 4 at 592:16-24; Tr. Vol. 3 at 349:12-20. This expectation is not inconsistent with the construct they adopt, which as Dr. Ordovery explained provides an economically and logically sound method for establishing the proper discount under which resellers will attempt to compete with Bell Atlantic to provide end-user retail service. Tr. Vol. 3 at 351:9-352:4, 354:12-355:8.

as Bell Atlantic in providing retail services to compete. Ordoover Test. at 12. As demonstrated by Dr. Ordoover, a discount which takes into account only the marginal costs of providing the retail service, and not the fixed costs as well, will mean that a reseller that incurs fixed costs may not be able to compete against Bell Atlantic, even where that reseller is more efficient. Ordoover Test. at 17-19; Tr. Vol. 3 at 361:22-362:15. Dr. Taylor admits that resellers will have fixed costs comparable to those retail related fixed costs incurred by Bell Atlantic, but while the resellers will recover those costs from the end-used customers, Bell Atlantic will charge its fixed costs to the resellers. Tr. Vol. 4 at 418:11-419:11. This plainly prevents competition by resellers who might otherwise compete efficiently with Bell Atlantic. Thus, all costs that can be reasonably attributed to Bell Atlantic's retail operations should be included as avoided costs.⁹

The theoretical construct of Bell Atlantic as a wholesale only provider is an economically and intellectually sound mechanism by which to anchor the wholesale discount in avoided cost analysis that is independent of the future success or failure of potential resale competitors of Bell Atlantic. Tr. Vol. 3 at 350:13-15; 354:12-355:1. The wholesale-only construct will promote economic efficiency by: (1) ensuring that Bell Atlantic will not charge resellers for costs Bell Atlantic incurs to compete at retail (Ordoover Test. at 28; Tr. Vol. 3 at 361:14-18); (2)

⁹ Emphasizing the "strategic importance of resale to the development of competition" (§ 907), the FCC correctly identified the operable theoretical construct stated in § 911:

We find that "the portion [of the retail rate] ... attributable to costs that will be avoided" includes all of the costs that the LEC incurs in maintaining a retail, as opposed to a wholesale, business. In other words, the avoided costs are those that an incumbent LEC would no longer incur if it were to cease retail operations and instead provide all of its services through resellers. Thus, we reject the arguments of incumbent LECs and others who maintain that the LEC must actually experience a reduction in its operating expenses for a cost to be considered "avoided" for purposes of section 252(d)(3). We do not believe that Congress intended to allow incumbent LECs to sustain artificially high wholesale prices by declining to reduce their expenditures to the degree that certain costs are readily avoidable. We therefore interpret the 1996 Act as requiring states to make an objective assessment of what costs are reasonably avoidable when a LEC sells its services wholesale.

stimulating entry by resellers whose long-run retail costs are lower than BA-MA's (Ordoover Test. at 15; Tr. Vol. 3 at 350:13-15); and (3) giving Bell Atlantic potent incentive to avoid retail-related costs to the maximum possible extent (Ordoover Test. at 15).¹⁰ AT&T's proposed method, therefore, promotes the sound policy of establishing a discount which will enable resellers whose long-run incremental retail costs are equal to or lower than Bell Atlantic to compete effectively. Tr. Vol. 3 at 346:9-16.

B. The Department In Its Phase 2 Order Concluded that the Wholesale-Only Construct Was the Proper Assumption to Achieve the Goals of the Act.

The Department in its Phase 2 Order concluded that the discount should be calculated as if the incumbent LEC was a wholesale only provider. Relying on § 252(d)(3) of the Act, the Department concluded that

Our goal should be to establish rates for resellers that only pay for the costs incurred by the ILEC to supply the wholesale services they are using and not the costs incurred by the ILEC to supply the retail services with which they are competing.

Phase 2 Order at 9. In order to carry out the Act in this regard, the Department determined that it had to establish a hypothetical telecommunications company providing only wholesale services, and to determine what its rates would be to resellers if it were run efficiently. *Id.* at 11, 13.¹¹ Thus, in order to determine the economically efficient rates to be charged for wholesale services by a wholesale only provider, the Department concluded that the wholesale discount should be based on a forward-looking view of avoided costs. *Id.* at 13. The

¹⁰ Dr. Taylor acknowledges that giving ILECs like BA-MA incentives to act efficiently is one of the goals of the 1996 Act. Tr. Vol. 4 at 430:2-12.

¹¹ The Department specifically noted that the debate between NYNEX and AT&T concerning whether to adopt the construct of a wholesale only-provider in evaluating the bucket of avoided costs, as AT&T urged, or whether to look at only those costs NYNEX would avoid as it shifted from being a retail supplier to a wholesale supplier, "is not informed by the Act or the Local Competition Order." Phase 2 Order at 12. Rather, the Department made an independent "finding on this conflict," *id.* at 12-13, concluding that fixed costs of providing retail services should be treated as avoided. *Id.* at 13-14.

Department rejected NYNEX's contention that retail-related costs which NYNEX claimed were volume-insensitive, or fixed, should be no be deemed avoided, because such costs could be avoided by an efficient wholesale provider. *Id.* Because, as discussed herein, the Department's analysis in the Phase 2 Order was consistent with sound economic principles promoting efficient competition, it should adopt that methodology again in this proceeding, and reject BA-MA's flawed methodology.

C. Bell Atlantic's Exclusion of Fixed Costs Is Antithetical to Efficient Competition.

Bell Atlantic's alternative methodology, purporting to reflect those costs that Bell Atlantic would avoid in shifting from a retail-only to a retail/wholesale environment, prevents competition by otherwise efficient resellers and encourages BA-MA not to avoid (or to deem "fixed" and not avoided) costs which benefit only Bell Atlantic. Bell Atlantic defines "fixed cost" as a cost which is volume-insensitive until the firm decides to cease providing retail services altogether. Taylor Direct at 8. A review of Bell Atlantic's cost study shows, however, that Bell Atlantic has included as fixed costs which cannot satisfy this strict definition.

Consider, for example, executive services (account 6711). BA-MA indicates that there are virtually no indirect avoided costs associated with executive expenses based on the mere assertion that nearly every function code listed reflects "fixed" costs. *See* Degnan Direct, attachment 2A at 7-8. Its assertions regarding which function codes within account 6711 are "fixed" are, however, utterly without support or explanation, and breakdown under minimal analysis. For example, while BA-MA may continue to have one president after the retail function is shed,¹² the \$15,000,000 costs in the executive services fund code (account 6711 /

¹² Even with respect to the president's salary, it is erroneous to conclude that such expenses are fixed at their current level regardless of the size and complexity of the organization. It would be surprising indeed if a
(continued...)

JFC 0001) necessarily include the salaries and expenses associated with numerous executive positions and responsibilities and support staff. Because some of these responsibilities currently include oversight, planning and administration of the marketing, sales, billing and collection, and other retail functions, there will be fewer responsibilities to discharge and fewer positions required in a resale environment. *See, Ordover Test.* at 21-22. BA-MA has not provided any specific information or documentation to show why that would not be the case; it has merely attached an assertion that nearly every function code in the account is fixed and not avoidable.

There is more reason to question Bell Atlantic's application of its "fixed" costs rule. It is fundamental that the avoided cost discount should not be based upon costs that Bell Atlantic itself chooses to avoid, because as an incumbent Bell Atlantic has powerful incentives not to avoid costs in order to minimize the wholesale discount (and thus the margin on which resellers can seek to compete). *Tr. Vol. 3* at 356:11-15; 357:1-2. Advertising expenses, which are addressed in more detail below, provide the most telling example to illustrate the theoretical and practical flaws in Bell Atlantic's approach of treating so called fixed costs as not avoided. Two other hypothetical examples, however, also demonstrate Bell Atlantic's errors.

The first hypothetical makes clear that Bell Atlantic's conception of fixed costs is directly at odds with how rational, efficient firms would behave. In his testimony, Mr. Goodrich demonstrated the indirect allocation factor using hypothetical apartment mates, Amy and Beth. *See Goodrich Test.* at 41-42. Ms. Degnan adopted that example as well, explaining that the expense of the common area in the apartment was an example of a fixed, not a variable cost.

Rebuttal Testimony of Margaret Mary Degnan dated September 8, 1998, BA-Phase II-4

(...continued)

statistical analysis of a large sample of companies did not show a strong correlation between the size and complexity of the company and the level of the president's salary and total remuneration. The portion of the President's salary attributable to retail activities should be removed when BA-MA sheds its retailing function.

("Degnan Rebuttal") at 7 of 9. In her live testimony, Ms. Degnan reiterated that if one tenant moved out, the other would be left to pay the entire cost of the common space as a fixed cost, and would be treated as such using the Bell Atlantic method. Tr. Vol. 4 at 530:10-531:17. Ms. Degnan then conceded that the economically rational thing for the remaining tenant would be to mitigate that cost, by for example moving to a new apartment. *Id.* at 531:4-15. Thus, while an economically rational and efficient actor would avoid the cost of the common space, Bell Atlantic asks the Department to adopt a study in which it simply deems such costs to be fixed and unavoidable.

The next example illustrates the problems in Bell Atlantic's analysis in a somewhat different way. Ms. Degnan conceded at the hearings that Bell Atlantic incurs certain costs which are completely discretionary, and that some such costs would be considered "fixed" costs for the purposes of Bell Atlantic's cost study. As an example, Ms. Degnan adopted the hypothetical of a large-screen television for executive use. Ms. Degnan acknowledged that such an expenditure was "fixed" as Bell Atlantic defined that term **B**not subject to change based on the volume of retail service provided **B** and that it would be treated as not avoided in Bell Atlantic's cost study although of absolutely no value to the services sold by Bell Atlantic. Tr. Vol. 4 at 486:11-21; 488:1-6. Permitting Bell Atlantic to identify such "fixed" costs as not avoided plainly distorts the calculation of the wholesale discount.

More importantly, the failure to treat, as avoidable, costs which - over the long term - are caused by provision of the retail function violates basic economic principles and prevents the development of efficient competition. BA-MA's treatment of indirect expenses as not avoidable is a violation of basic economic principles because it essentially takes a *short run* view of avoidable expenses. Only in the long run will all costs related to the retail function become truly

variable.¹³ While the Act does not expressly state which view should be taken,¹⁴ only a long run view will measure all the economic costs associated with the retail function and, therefore, produce a wholesale discount rate that encourages efficient competition at retail. To the extent that there is any ambiguity in the words "will be avoided," the Department should treat as avoidable *all* costs that can be shed with the retail function over the long-run, not just those that are avoided in the short-run.

III. ADVERTISING EXPENSES MUST BE TREATED AS AN AVOIDABLE EXPENSE.

A. The Department Must Reject Bell Atlantic's Assertion That Advertising Costs It Expends To Compete Against Resellers Purchasing Its Wholesale Service Should Be Included In The Wholesale Price Charged For That Service.

Bell Atlantic's treatment of its advertising expenses is an excellent example of how Bell Atlantic's assertion that fixed costs are not avoided perverts its analysis. In support of its treatment of advertising costs as 100% not avoided when submitting its cost study, BA-MA asserts that product advertising is a fixed cost that does not vary with the level of retail output, and therefore, is not avoided. Degnan Direct at 7; Rebuttal Testimony of William E. Taylor on Behalf of Bell Atlantic-Massachusetts dated September 8, 1998, BA-Phase II-2 ("Taylor Rebuttal") at 11-13. Bell Atlantic not only acknowledges that 100% of its current advertising costs are spent to promote its retail products (Tr. Vol. 4 at 490:10-19), but indeed *relies* on the continuation of its retail advertising as support for its argument that such costs are not avoided. Taylor Rebuttal at 12 ("[AT&T] ignores the fact that [Bell Atlantic] will continue to advertise to

¹³ Dr. Taylor concedes that fixed costs are variable in the long-run. Tr. Vol. 4 at 409:11-16.

¹⁴ Section 252(d)(3) states that wholesale rates should be determined "on the basis of retail rates ... excluding the portion thereof attributable to any marketing, billing, collection and other costs *that will be avoided* by the local exchange carrier." (Emphasis supplied.) It does not expressly state the time period over which the costs will be avoided.

support its own retail services"). Advertising costs thus form the most brazen example of BA-MA's attempt to include within its wholesale rates costs that Bell Atlantic incurs solely for the purpose of competing with the purchasers of its wholesale services in the retail market.

Inclusion of retail advertising expenses in wholesale rates would effectively permit BA-MA, as the monopoly provider of wholesale service, to tax its retail competitors in order to finance advertising campaigns against them. *See Ordoover Test.* at 30; Tr. Vol. 3 at 361:19-362:8.

In fact, Dr. Taylor specifically asserts that the fact that advertising expenses help BA-MA compete in the retail markets is "irrelevant" to the analysis. Taylor Rebuttal at 12; Tr. Vol. 4 at 437:1-4. As AT&T has demonstrated, far from being an irrelevant consideration, requiring resellers to pay wholesale rates which do not exclude Bell Atlantic's advertising costs, where they will be required to incur their own costs as well, will prevent competition by efficient resellers. Tr. Vol. 3 at 361:19-362:8. Bell Atlantic's incredible assertion that *retail* advertising costs should be deemed not avoided because it will continue to incur them as it shifts from retail to wholesale service reveals the core of the problem with BA-MA's treatment of "fixed" costs and must be rejected.

B. Bell Atlantic's Unsupported Claims That It Will Incur Costs As a Wholesale Advertiser Fail.

Recognizing the lack of support for its assertion that its retail advertising costs are unavoidable, Bell Atlantic offers yet another assertion: even as a pure wholesaler, BA-MA will be required to spend as much on advertising as it does today on its retail services. Taylor Rebuttal at 13; Degnan Rebuttal at 6 of 9.

BA-MA offers Ms. Degnan's cursory assertions and Dr. Taylor's testimony in support of its contention that a monopolist wholesaler would continue to advertise after resellers take over the retailing function and engage in vigorous advertising themselves. Both are utterly lacking

support. Experience demonstrates that monopoly wholesalers do not advertise. First and foremost, Ms. Degnan conceded that BA-MA itself does not advertise its interexchange access, the wholesale input for long distance service. Tr. Vol. 4 at 490:10-19. Rather, as Dr. Ordoover points out, BA-MA relies on retailers like AT&T, MCI and Sprint to advertise long distance service. Tr. Vol. 3 at 314:23-315:2; 333:11-334:23. In addition, Dr. Ordoover also noted that wholesale providers of long-distance minutes such as AT&T do not advertise their wholesale service. Tr. Vol. 3 at 326:14-22; 330:12-20. Moreover, monopolist wholesalers have even less incentive to advertise than wholesalers generally (*id.* at 317:2-6); as Dr. Ordoover testified, wholesalers only have incentive to advertise when they are in competition with other wholesalers. *Id.* at 316:11. BA-MA simply does not have competitors for wholesale services. Indeed, as Dr. Ordoover and Dr. Taylor agree, resellers have every incentive to stimulate retail demand, obviating the need for further expenditure by BA-MA as a wholesaler to achieve the same end. Tr. Vol. 3 at 334:17-23; Vol. 4 at 437:16-438:1.

It is thus both implausible that BA-MA will advertise its wholesale services, and unnecessary. *See* Phase 2 Order at 19-20; Tr. Vol. 3 at 334:17-23. As the Department correctly noted in its Phase 2 Order, even if one assumes that a monopoly wholesaler has an interest in expanding its business, the retailers have precisely the same interest in expanding their businesses. Phase 2 Order at 19. Retailers will, in seeking to differentiate their branded retail product, spend money on advertising to maximize their profitability, thereby stimulating the market for the underlying wholesale service. *Id.* at 20.¹⁵ In sum, BA-MA's unsupported assertions that it will incur advertising costs as a wholesaler are refuted by current experience,

¹⁵ While the Department's findings that an efficient monopoly wholesale company would not advertise resulted in the conclusion that NYNEX had not overcome the FCC presumption that advertising costs are avoidable, the finding itself was based on independent evidence regarding advertising practices and economic theory and should be followed again in this proceeding.

economic theory and common sense. Bell Atlantic's contention that advertising cost will be 100% not avoided must be rejected, and all such costs treated as avoided expenses in calculating the wholesale discount.

IV. CONTRARY TO BA-MA'S AVOIDED COST STUDY, PRODUCT MANAGEMENT EXPENSES MUST BE TREATED AS AN AVOIDABLE EXPENSE.

BA-MA has taken the position that none of its product management expenses would be avoided if BA-MA were a pure wholesaler. As in the case of advertising, nowhere does BA-MA provide any evidence of "specific costs in [the product management account that] will be incurred." *See* FCC Order, ¶ 917.¹⁶ Instead, BA-MA makes the same broad brush type assertion with respect to product management expenses that it made regarding advertising expenses. BA-MA merely asserts that the majority of such expenses are incurred to support BA-MA products which are offer at both retail and wholesale (since all retail services must be offer at wholesale under the Act), and therefore are not avoided. Tr. Vol. 4 at 492:7-14.

BA-MA's analysis fails, however, to take into account the proper construct of BA-MA as a wholesale only provider. BA-MA ignores the fact that it is selling to resellers who have a sharp, compelling interest in determining market demand for new products. Goodrich Test. at 31. Resellers will provide such functions, and it would no longer be efficient for BA-MA as a wholesale provider to spend scarce dollars on competitive analysis of retail markets, retail test marketing, or retail pricing analysis. As Mr. Goodrich testified, it is the firm serving the end-user customer that is best able to identify customer needs and to spend product management dollars accordingly. ; Tr. Vol. 4 at 590:16-591-1; 606:9-20 In such a circumstance, as CTC

¹⁶ The FCC adopted the presumption that all product management expenses are avoidable because resellers would provide such services themselves or contract for them separately. As discussed herein, the Department should adopt a similar presumption for those reasons.

Communications' witness Dr. Kelley pointed out, wholesalers look to their resellers as proxies for end-user product needs, or perhaps share with them the costs of product management issues. *Id.* at 619:2-11; 620:16-20. As a wholesale provider, Bell Atlantic would have at most a very small fraction of its current product management expenses. *Id.* at 582:17-24. Bell Atlantic's cost study offers only evidence of product management costs incurred in 1996 to support retail activities, but no analysis of what costs it would incur as a wholesale provider. If Bell Atlantic wishes to include such costs in its wholesale rates, it should prove what its wholesale costs would be. *Id.* at ____

Even in the "real world" of BA-MA as both a retail and a wholesale provider, when BA-MA continues to perform these functions, it will do so solely for the benefit of its retail operations in competition with, rather than to the benefit of, resellers. From a cost causation point of view, BA-MA should not be permitted to recover these costs in its wholesale rates. BA-MA's contention that certain product management costs will be 100% avoided implies that, from a causation point of view, product management serves only the wholesale function and provides no value to the retail function. This, on the face of it, is wrong. BA-MA provides retail services and expends product management resources to support them, not its wholesale service. The fact that BA-MA is required by the 1996 Act to offer the same services at wholesale to resellers that it offers at retail does not alter the fact that BA-MA incurs such costs to support its retail services. BA-MA should not be allowed to recover these costs from its competitors through wholesale rates. Allowing it to do so would undercut the overarching objective of promoting competition.

V. AT&T'S AVOIDED COST STUDY TREATS ALL EXPENSES CAUSED BY OPERATOR SERVICES AND DIRECTORY ASSISTANCE AS AVOIDABLE, TO THE EXTENT THAT THEY ARE NOT RECOVERED BY THE SEPARATE REVENUES ASSOCIATED WITH SUCH SERVICES; BA-MA'S AVOIDED COST STUDY DOES NOT.

AT&T and BA-MA agree that the proper way to handle operator and directory assistance accounts in an avoided cost study is to treat any shortfall that arises as a result of revenues being less than costs as an avoided loss when the reseller takes over the operator and directory assistance functions. *See, e.g.,* Degnan Direct at 8; Goodrich Test. at 11-12. It is this avoided loss then that is an avoided cost.¹⁷ The parties moreover agree that it is appropriate to calculate a separate (higher) wholesale discount rate for resellers who will provide their own operator and directory assistance services than the discount rate available to resellers who purchase such services from BA-MA.

Both parties treat the expenses in accounts 6621 (call completion services) and 6622 (number services) as avoidable costs in providing service to resellers that will use their own operator services. In addition, both parties reduce the total revenues from services subject to resale when calculating the discount for resellers who provide their own O+DA. *See* Tr. Vol. 4 at 549:6-12, compare Goodrich Test. Ex. 1 *with* Ex. 3 (reflecting different total revenue figures for calculating discount with and without operator services). AT&T's cost study, therefore, comports with Dr. Taylor's distinction between retail services and retail functions, because in calculating the discount, it removes revenues BA-MA would otherwise realize from the retail service (O+DA) it will not provide for the benefit of certain resellers.¹⁸

¹⁷ Here again, the parties' respective calculations of the shortfall differ because BA-MA, rather than using its own recorded expenses, improperly applies the separations process to calculate the "intrastate" expenses in each account.

¹⁸ The Department need not spend much time on Dr. Taylor's distinction between retail services and retail functions. The only example of a retail service offered by Dr. Taylor is O+DA. *See* BA B Phase II-1 at 4, for which AT&T properly accounts, by counting the cost savings to BA-MA as an avoided cost while also reducing

(continued...)

The parties differ, however, over the costs recorded in account 6560 (depreciation and amortization) associated with operator systems. AT&T contends that such costs will also be avoided when BA-MA provides wholesale services to resellers that will not use BA-MA's operator services. Goodrich Test. at. 34-35. The costs in account 6560 included by AT&T as avoided have been identified clearly as costs associated with a service that will be avoided (operator services), and BA-MA has offered no evidence to the contrary. BA-MA simply relies on the assertion that such costs are fixed. Degnan Rebuttal at p. 8 of 9. Moreover, even assuming BA-MA retained assets it was not using to provide services (rather than acting rationally to shed such costs), if the unamortized balance of such equipment is placed into wholesale rates, it would confer a permanent advantage on Bell Atlantic, because it could recover retail-related fixed costs through a wholesale charges to resellers who are not using the services/assets in question. See Phase 2 Order at 31. This assertion makes no sense on its face. If BA-MA is not providing O+DA services, it need not have the assets. The costs recorded in account 6560 must therefore be treated as avoided.

For the same reason, as discussed below, AT&T's cost study properly includes among the indirect avoided costs, taxes and return associated with such assets. BA-MA will not need to provide O+DA services to resellers who provide their own, and such resellers should not pay any amounts related to services they are not using.¹⁹ See Goodrich Test., Ex. 2 p. 2 of 3 (line 28).

(...continued)

the revenues subject to resale. Compare Ordoover Test., Ex. 1 p. 1 of 3; with Ex. 3 p. 1 of 3 (reflecting different figures for total revenue subject to resale).

¹⁹ Because resellers providing their own O+DA will reduce the demand for BA-MA operator services, BA-MA will require fewer personnel and assets related to O+DA. Behaving as an efficient firm, BA-MA will shed those assets.

VI. BA-MA'S TREATMENT OF INDIRECT EXPENSES VIOLATES ECONOMIC PRINCIPLES OF EFFICIENT COMPETITION AND THE BASIC MATHEMATICAL PRINCIPLE OF PROPORTIONALITY.

BA-MA and AT&T are far apart in terms of the size of the avoided indirect expenses that are identified as a result of fundamental methodological differences.

A. AT&T Calculates Indirect Expenses By Applying An Allocation Factor.

The parties agree that it is appropriate to treat certain overhead and other indirect expenses as avoided because a portion of Bell Atlantic's general overhead is reasonably attributable to Bell Atlantic's retail operations. By their very nature, such avoidable indirect costs are difficult to quantify. In order to reasonably approximate such costs, AT&T applies an allocation factor based on the ratio of avoided direct expenses to total direct expenses. Both the FCC in its Local and its Phase 2 Order (at 22-23) have approved this allocation factor as a reasonable mechanism for calculating avoided indirect costs. AT&T calculates an indirect allocation factor of 23.11%, to be applied to indirect expenses other than uncollectibles.

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B. BA-MA's Treatment Of The Indirect Expenses Or So Called "Secondary" Expenses As Not Avoidable Violates Economic And Accounting Principles Promoting Efficient Competition At The Retail Level.

In analyzing indirect costs, Bell Atlantic rejects uniform application of an indirect allocation factor and purports to undertake a review of each function code within each indirect expense account. Bell Atlantic begins by analyzing which of such expenses are "fixed" and which are "variable." As with direct costs, Bell Atlantic determined, with respect to indirect expenses, that "If the expenses are fixed, and do not vary whether the activity is required in a

²⁰ See note ____, *supra*.

retail or a wholesale environment, they are not avoided." As discussed above, this is not the appropriate premise. An avoided cost analysis should reflect the avoidance of all Bell Atlantic costs from which resellers derive no benefit. Whether or not the costs are more fixed than variable (as Bell Atlantic alleges) is completely irrelevant. Bell Atlantic makes the same fundamental error discussed in detail above with regard to direct costs (and specifically advertising expenses) when it deems costs to be fixed and therefore not avoided.

With respect to indirect costs, Bell Atlantic then goes on to determine (for "variable" indirect costs) the portion of indirect costs avoided by assigning to each such cost the "avoided secondary method" applicable to "the function being supported." The very nature of the General & Administrative indirect expenses suggests that an analysis of the type Bell Atlantic has undertaken is not particularly meaningful. That is, if the expenses incurred in these accounts could readily be attributed to the direct expense accounts, such as product management, sales, advertising, customer accounting, and the like, generally accepted accounting principles of cost causation would dictate that the expenses be booked directly to the direct expense accounts. Goodrich Test. at 38-39; Phase 2 Order at 23. These expenses are not booked directly to these accounts because it is difficult to determine their causality. It is entirely reasonable, however, to expect a portion of all the indirect expenses to support the direct retail operations currently provided by Bell Atlantic.

BA-MA's asserted refinement **B** reviewing indirect or "secondary" expenses to "assign" them to direct cost categories is not a meaningful exercise. Such assignment occurs with respect to a very low percentage of the job function codes analyzed. The two principle "avoided secondary methodologies" (*see* Degnan Direct, attachment 2A, column F) employed are:

- (1) The (erroneous) allocation factor based on avoided direct costs to total codes (Method E); and

(2) The improper not avoided/"fixed" cost category (Method G).

By even BA-MA's assessment, there are a scant number of remaining "secondary" job function codes **B** fewer than fifteen out of approximately 250 **B** that can purportedly be "assigned" to a direct cost category. BA-MA's purported "refinement" is merely a means to assert what BA-MA asserted in Phase 2 of the arbitration **B** that large amounts of overhead expenses are not "avoidable." BA-MA's smoke-screen cannot mask what the Department recognized in Phase 2 of the Arbitration, that the company cannot present a supportable case on indirect expenses which is as reasonable as the indirect-cost ratio method used by AT&T (and selected by the FCC).

The FCC has said that corporate operations expenses (accounts 6711, 6712, 6721-6728) are tied to the overall level of operations and can, therefore, reasonably be presumed to decline with the loss of existing retail functions. FCC Order, ¶ 918. The Department itself in the Phase 2 Order found that "the FCC properly recognized the difficulty of undertaking an account by account review of indirect expenses to determine which percent of each account is avoidable." Phase 2 Order at 25. Even with the shift in focus from the account to the function code level, BA-MA fails to cure the basic confusion: BA-MA apparently equates the fact that the *type* of expense will continue with an (unsupported) prediction that the *level* of expense to support a (reduced or eliminated) retail function will continue. BA-MA's bald assertion that such overhead is "fixed" defies common sense and basic economics, as a review of the accounts other than executive (account 6711, discussed above) for which BA-MA claims it will avoid no (or a de minimus level of) expenses are discussed below.

Planning (account 6712). Apparently believing that the level of planning activity is precisely the same for a company selling to a market of millions as it is for a company selling to

a market of a dozen or two, BA-MA contends that the level of planning expenses would not be different in a wholesale environment. Such a contention is meritless on its face. It implies that none of BA-MA's current planning activities relate to marketing, sales, billing and collections, or any other retail functions. AT&T's approach of treating as avoidable a portion of these costs (in proportion to the percentage of direct expenses that are avoidable) is much more reasonable.

Accounting and Finance. BA-MA's study assumes that there are few indirect avoided costs associated with the 6721.2 subaccount, which includes costs incurred for general accounting activities such as journals, ledgers, and financial reports. While some general accounting activities will no doubt continue in an all wholesale environment, it is reasonable to conclude that a firm of reduced size, scope and complexity will require a reduced level of such activities. Although many of the *type* of activities will continue, their *level* will be reduced. *Id.* For example, while it will still be necessary to prepare and file financial reports, with the elimination of marketing, billing, collection and sales functions, there will be fewer functions and activities whose costs are recorded in those reports. It will, therefore, require fewer resources to prepare them. Therefore, treating as avoidable a portion of these costs, as recommended by the FCC and AT&T, is more reasonable than flatly assuming no change.

External Relations. BA-MA's study assumes that there are no indirect avoided costs associated with the 6722.4 subaccount (connecting company relations) and subaccount 6722.5 (regulatory and government relations). Here again, it is more reasonable to assume that a firm of reduced size, scope and complexity will necessarily incur fewer costs in these areas. Issues of marketing, sales, billing and collection no doubt arise in relations with independent telephone companies and with regulators. Indeed, retail customer complaints made to the Department of Public Utilities regarding poor service, missed repair appointments and incessantly busy "help

lines" with which BA-MA must routinely deal would disappear in an all wholesale environment.

Legal. BA-MA's study assumes that its legal expenses would be no different in an environment in which it sells to and collects payments from a dozen purchasers compared to an environment in which its customers number in the millions. At a minimum, retail collection and complaint activity would decrease. Therefore, treating as avoidable a portion of these costs, as recommended by the FCC and AT&T, is more reasonable than flatly assuming no change.

C. Even Bell Atlantic's Indirect Cost Ratio (Secondary Method E) is Incorrect as a Matter of Simple Math.

The second reason that BA-MA's Avoided Cost Study estimates far lower avoidable indirect expenses than does AT&T's is simple math. To the extent that indirect expenses are considered avoidable in proportion to the percentage of direct expenses that are avoidable, underestimating the percentage of direct costs that are avoided will cause an underestimate of the indirect expenses that are considered avoidable. This problem is cured when the correct percentage of direct expenses that are avoidable is determined. Clearly, to be proportional, the proportion of indirect costs that are avoided must be the same as the proportion of direct costs that are avoided. BA-MA's interpretation does not produce this result.

The BA-MA calculation estimates the percentage of indirect expenses that are avoided, not on the basis of the percentage of direct expenses that are avoided (*i.e.*, avoided direct expenses divided by total direct expenses), but rather on the basis of the meaningless fraction, avoided direct expenses divided by the sum of total direct expenses and total indirect expenses. The flaw in this approach is cogently illustrated by the "April and Beth" hypothetical in Mr. Goodrich's Testimony at p. 22. April and Beth share a two bedroom apartment which costs \$1000 a month to rent. The apartment has 1000 square feet. Each bedroom is 300 square feet and there is common space (*i.e.*, indirect space) of 400 square feet. Even though each of the two

women has her own bedroom and shares equally in the common space, Beth estimates that she owes only \$420 of the \$1000 monthly, while April owes \$580. She reached this result because she applied the BA-MA methodology proposed in this proceeding for allocating indirect costs. Rather than allocating the common space on the basis of the percentage that each women occupies of the non-common space (*i.e.*, 50%), Beth allocated the cost of the common space to herself on the basis of a fraction defined as her own non-common (bedroom) space (300 square feet) divided by total space (1000 square feet), *i.e.*, Beth allocated only 30% of the cost of the common space to herself. The fallacy of this approach is revealed if April were to try the same trick. Not all of the cost of common space is allocated. Likewise, BA-MA's methodology for allocating indirect expenses between avoidable and not avoidable does not, in fact, allocate all the expenses. It is plainly wrong as a matter of mathematics. As the Department ruled in the Phase 2 Order:

A ratio constructed by dividing avoided direct expenses by total expenses simply does not mean much. The "total expenses" portion already contains all of the indirect expenses, the number we are seeking to divide into avoidable and unavoidable fractions. Its inclusion in this fraction therefore seems to have as its main virtue the production of a relatively low indirect cost ratio. In contrast, the ratio of avoided direct expenses to total direct expenses offers consistency in the numerator and denominator of the fraction. In the absence of a reason to believe that indirect costs would be differently divided between avoidable and unavoidable as direct expenses, it is reasonable to apply that same ratio to total indirect costs.

Phase 2 Order at 23.

Finally, in considering the proper treatment for the indirect categories, the Department should find that LECs need not actually experience a reduction in its operating expenses for a cost to be considered "avoided" for purposes of § 252(d)(3). *See*, FCC Order, ¶ 911. BA-MA cannot, therefore, simply assert that these indirect costs will not change. As long as they reasonably should change, they should be treated as avoided costs. Indirect costs should change

with the reduced retail functions, absent clear proof to the contrary. BA-MA has presented no such proof.

VII. AT&T PROPERLY TREATS A PORTION OF COSTS ASSOCIATED WITH OPERATING TAXES (ACCOUNT 7240) AS AVOIDED.

AT&T's Avoided Cost Study includes a portion of the operating taxes account (account 7240) as avoided, except for personal property taxes. The portion of these expenses considered avoided was determined using the indirect expense ratio. It is appropriate to include a portion of these operating taxes as avoided because they are principally real estate taxes associated with avoided retail land and building investment.

VIII. IT IS ALSO APPROPRIATE TO CALCULATE AVOIDED COSTS FOR THE RETURN AND TAXES ASSOCIATED WITH OPERATOR SYSTEMS AND GENERAL SUPPORT INVESTMENTS.

AT&T's Avoided Cost Study properly includes the return on capital invested in operator systems and general support assets. For wholesale customers who choose not to purchase operator and directory assistance services from Bell Atlantic, all of the return on capital associated with operator system assets should be considered as avoided.

Similarly, a portion of the return on capital invested in general support assets is avoided given that a portion of Bell Atlantic's general support assets are used to support the retail business and are not required in the provision of wholesale business. Further, the FCC explicitly found the concept of removing the return associated with avoided retail activities as consistent with the Telecommunications Act (see Local Competition Order at paragraph 913).

Furthermore, in its Phase 2 Order the Department found that all of the return and taxes associated with operator systems are avoided when resellers provide their own operator and directory assistance services, and a portion of the return and taxes associated with general support assets are avoided, as is reflected in AT&T's avoided cost analysis. See Order on

motions for reconsideration and clarification dated February 5, 1997 ("Phase 2-A Order") at 7-8.

Specifically, the Department found the following:

"To clarify our Phase 2 Order, we did intend that the return portion of operator and directory assistance ("O+DA") services should be treated in parallel with the depreciation and amortization expenses, for the same reasons set forth in the order with regard to Account 6220 and 6550, operator system expenses and depreciation and amortization associated with operator system assets."

In addition, the Department stated:

"Likewise, just as the amortization and depreciation of general support activities unrelated to any specific function that could be avoided have been treated as indirect avoidable costs, the return on such activities should also be considered."

Conclusion

For the reasons set forth above, the Department should reject BA-MA's approach and adopt AT&T's methodology for calculating the avoided cost discount factor necessary to determine efficient wholesale rates. Bell Atlantic's cost study suffers from several fundamental flaws in methodology and application that would, if adopted, prevent competition by efficient resellers, in contradiction to the goals of the 1996 Act. AT&T's avoided cost study, by contract, promotes the establishment of economically efficient wholesale rates. AT&T's study demonstrates that the Department should adopt a wholesale discount of 30.75% for resellers providing their own operator and directory assistance services and 25.83% for resellers purchasing such services from Bell Atlantic.

AT&T COMMUNICATIONS OF
NEW ENGLAND, INC.
By its attorneys,

Jeffrey F. Jones
Laurie S. Gill
Jay E. Gruber
Kenneth W. Salinger
Joseph F. Hardcastle
Matthew P. Schaefer
PALMER & DODGE LLP
One Beacon Street
Boston, MA 02108
(617) 573-0100

Melinda T. Milberg
32 Avenue of the Americas
New York, New York 10013
(212) 387-5627

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